

BEFORE THE DEPARTMENT OF REVENUE  
OF THE STATE OF MONTANA

In the matter of the proposed adoption of	)	NOTICE OF PUBLIC
New Rule I and II relating to gains	)	HEARING ON PROPOSED
calculations and voluntary disclosure	)	ADOPTION

TO: All Concerned Persons

1. On March 2, 2006, at 1:30 p.m., a public hearing will be held in the Director's Office (Fourth East) Conference Room of the Sam W. Mitchell Building, at Helena, Montana, to consider the adoption of the above-stated rules relating to gains calculations and voluntary disclosure.

Individuals planning to attend the hearing shall enter the building through the east doors of the Sam W. Mitchell Building, 125 North Roberts, Helena, Montana.

2. The Department of Revenue will make reasonable accommodations for persons with disabilities who wish to participate in this public hearing or need an alternative accessible format of this notice. If you require an accommodation, contact the Department of Revenue no later than 5:00 p.m., February 21, 2006, to advise us of the nature of the accommodation that you need. Please contact Cleo Anderson, Department of Revenue, Director's Office, P.O. Box 7701, Helena, Montana 59604-7701; telephone (406) 444-5828; fax (406) 444-3696; or e-mail canderson@mt.gov.

3. The proposed new rules do not replace or modify any section currently found in the Administrative Rules of Montana. The proposed new rules provide as follows:

NEW RULE I NONRESIDENT CALCULATION OF MONTANA SOURCE INCOME REALIZED AND RECOGNIZED WHEN MONTANA PROPERTY IS RELINQUISHED AS PART OF A SECTION 1031 EXCHANGE (1) Gain realized on the transfer of Montana real or tangible personal property retains its Montana source income character and must be reported if and when the gain is recognized for federal income tax purposes.

(2) When the Montana property is relinquished in a section 1031 exchange for like-kind property, the gain realized as shown on the taxpayer's U.S. Treasury Form 8824 is generally the amount of Montana source income. If, however, the Montana property was itself acquired in a prior like-kind exchange as replacement property for property located outside the state, Montana source income does not include the gain attributable to the out-of-state property that has been deferred from the prior exchange as shown on the taxpayer's U.S. Treasury Form 8824 for that exchange. The following examples illustrate how the Montana source income may be calculated in different situations:

(a) Example 1 - A nonresident relinquishes unimproved Montana land with a fair market value of \$100,000 and an adjusted tax basis of \$10,000 in exchange for

Wyoming property with a fair market value of \$90,000 and \$10,000 cash, and incurs exchange expenses of \$2,000. The \$88,000 realized gain reported on the taxpayer's Form 8824 is Montana source income, of which \$8,000 is recognized and reportable in the year of sale and \$80,000 is deferred and must be reported if and when the gain is recognized for federal income tax purposes:

Form 8824 filed with respect to Montana property relinquished		
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses	8,000
16	FMV of like-kind property you received	90,000
17	Add lines 15 and 16	98,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15	10,000
19	Realized gain (or loss). Subtract line 18 from line 17	88,000
20	Enter the smaller of line 15 or line 19, but not less than zero	8,000
21	Ordinary income under recapture rules	0
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies	8,000
23	Recognized gain. Add lines 21 and 22	8,000
24	Deferred gain (or loss). Subtract line 23 from line 19	80,000
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23	10,000

(b) Example 2 - Same facts as in (2)(a) except the Montana property included improvements with a fair market value of \$12,000 and \$1,000 is reportable as ordinary income under the recapture rules because of depreciation deductions taken with respect to those improvements. The result is the same as the result in (2)(a), except that \$1,000 of the \$8,000 Montana source income recognized and reportable in the year of sale is ordinary income.

Form 8824 filed with respect to Montana property relinquished		
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses	8,000
16	FMV of like-kind property you received	90,000
17	Add lines 15 and 16	98,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15	10,000
19	Realized gain (or loss). Subtract line 18 from line 17	88,000
20	Enter the smaller of line 15 or line 19, but not less than zero	8,000
21	Ordinary income under recapture rules	1,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If	7,000

	more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies	
23	Recognized gain. Add lines 21 and 22	8,000
24	Deferred gain (or loss). Subtract line 23 from line 19	80,000
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23	10,000

(c) Example 3 - Same facts as in (2)(a) except the Montana property relinquished was replacement property exchanged for Oregon property in a prior like-kind exchange. In the prior like-kind exchange, the deferred gain or loss, as shown on the nonresident's Form 8824 was \$50,000. The nonresident's Montana source income is \$38,000, the \$88,000 gain realized shown on the Form 8824 filed with respect to relinquishment of the Montana property, less the \$50,000 deferred gain as reported on the Form 8824 filed with respect to relinquishment of the Oregon property. Of the \$38,000 Montana source income realized, the \$8,000 recognized for federal income tax purposes in the year of sale is currently reportable and \$30,000 is deferred and must be reported if and when the gain is recognized for federal income tax purposes.

Form 8824 filed with respect to Oregon property relinquished		
24	Deferred gain (or loss). Subtract line 23 from line 19	50,000

Form 8824 filed with respect to Montana property relinquished		
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses	8,000
16	FMV of like-kind property you received	90,000
17	Add lines 15 and 16	98,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses not used on line 15	10,000
19	Realized gain (or loss). Subtract line 18 from line 17	88,000
20	Enter the smaller of line 15 or line 19, but not less than zero	8,000
21	Ordinary income under recapture rules	0
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies	8,000
23	Recognized gain. Add lines 21 and 22	8,000
24	Deferred gain (or loss). Subtract line 23 from line 19	80,000
25	Basis of like-kind property received. Subtract line 15 from the sum of lines 18 and 23	10,000

(3) The nonresident must report the deferred Montana source income realized on the relinquishment of the Montana property if and when the gain is recognized for federal income tax purposes. The amount of Montana source income recognized will never exceed the gain recognized for federal income tax purposes. The

following examples illustrate how the Montana source income may be calculated in different situations:

(a) Example 1 - Same facts as in (2)(a). In a later tax year the Wyoming replacement property is sold for \$150,000, the taxpayer reporting taxable gain of \$140,000 on their federal income tax return. The nonresident's \$80,000 of Montana source income realized on the Montana property exchange that was deferred has been recognized for federal income tax purposes and must be reported as Montana source income when the nonresident files the Montana individual income tax return required in 15-30-105, MCA.

(b) Example 2 - Same facts as in (3)(a), except the Wyoming replacement property is sold for \$60,000 and \$50,000 of taxable gain is reported on the taxpayer's federal income tax return. While \$80,000 of Montana source income was realized but deferred on relinquishment of the Montana property, only \$50,000 was recognized for federal income tax purposes. The nonresident must report the \$50,000 of Montana source income recognized when the nonresident files the Montana individual income tax return required in 15-30-105, MCA.

(c) Example 3 - Same facts as in (3)(a), except improvements with a cost of \$75,000 are erected on the Wyoming property and depreciation deductions of \$15,000 are claimed with respect to those improvements before the improved Wyoming property is sold for \$150,000. On the date of sale the fair market value of the improvements, which have an adjusted basis of \$60,000, is \$70,000, and the fair market value of the Wyoming property acquired in the exchange, which has an adjusted basis of \$10,000, is \$80,000. Of the \$80,000 of deferred Montana source income realized on relinquishment of the Montana property, \$70,000 has been recognized for federal income tax purposes and must be reported when the nonresident files the Montana individual income tax required in 15-30-105, MCA.

(d) Example 4 - Same facts as in (2)(c). The Wyoming replacement property is sold for \$150,000. The \$30,000 deferred Montana source income realized on relinquishment of the Montana property has been recognized for federal income tax purposes and must be reported when the nonresident files the Montana individual income tax return required in 15-30-105, MCA.

AUTH: 15-1-201 and 15-30-305, MCA

IMP: 15-30-101, 15-30-103, 15-30-105, 15-30-131, 15-30-132, 15-30-1102, 15-30-1111, and 15-30-1112, MCA

REASONABLE NECESSITY: The department is proposing to adopt New Rule I to address comments received during and subsequent to the hearing held on December 29, 2005 for MAR Notice No. 42-2-754. Many of those commenting on the proposed amendment to ARM 42.2.204, which was contained in MAR Notice No. 42-2-754, suggested that the department should consider a rule addressing how the Montana source income statute and rule affect gain calculations and basis when Montana property is relinquished or acquired in a like-kind exchange. Proposed New Rule I outlines and provides examples of how the characterization of gain as Montana source income relates to the calculation of the amount of gain realized and reported for federal income tax purposes.

NEW RULE II VOLUNTARY DISCLOSURE (1) A person who transferred Montana property in a section 1031 like-kind exchange on or after December 31, 2001, who recognized some or all of the gain, including boot, realized on the exchange for federal income tax purposes while a nonresident, and who has not met their Montana filing and tax obligations may fulfill their filing and tax obligations without assessment of penalty and part of the applicable interest.

(2) A taxpayer qualifies for the voluntary disclosure program if the taxpayer is described in (1) and did any of the following:

(a) failed to file a return and pay any tax due for a tax year beginning after 2001; or

(b) underreported tax for any tax year beginning after 2001.

(3) A taxpayer does not qualify if:

(a) the taxpayer has been contacted by the department about filing or paying the same delinquent taxes;

(b) the taxpayer has been a party to any criminal investigation or pending civil or criminal litigation for nonpayment, delinquency, or fraud in relation to any tax due; or

(c) one of the tax years is included in an ongoing or unresolved audit.

(4) If the taxpayer qualifies the taxpayer must notify the department by filing the appropriate returns and paying the tax due beginning May 1, 2006, and ending August 31, 2006 and clearly indicating on each return and any separate correspondence that the taxpayer wishes to take advantage of the voluntary disclosure program.

(5) If a taxpayer comes forward under the voluntary disclosure program, the department and the taxpayer will enter into a signed agreement which recognizes that the taxpayer had a filing and tax obligation and that the department will be waiving all penalties associated with voluntary disclosure program and one-half of any interest owed or \$100 of accrued interest per tax period, whichever is greater.

(6) The department reserves its right to audit a taxpayer's books and records, subject to statutory time limits. The audit may include all or part of the periods covered under the voluntary disclosure program. The department will assess any tax determined to be due that was not discharged under the voluntary disclosure program. All applicable penalties and interest will apply to additional taxes discovered to be due that have not been paid. If any of the factual representations made in the voluntary disclosure program are found to have been materially misrepresented or a material fact is found to have been omitted by the taxpayer or its representative, the department may reassess the waiver of any penalties and interest that occurred based on the provisions in (1) through (6).

(7) The application of this rule shall expire on September 1, 2006.

AUTH: 15-1-201, 15-1-211, and 15-30-305, MCA

IMP: 15-1-206, 15-30-101, 15-30-105, 15-30-142, and 15-30-304, MCA

REASONABLE NECESSITY: The department has determined that nonresidents who relinquished Montana property in a like-kind exchange after December 31, 2001, when the definition of "Montana source income" became effective, may not have been fully apprised of their duty to report to Montana any gain realized and

recognized that is Montana source income. The department has further determined that it would be in the interest of fair and efficient tax administration to allow them to voluntarily come forward to file returns and pay their Montana tax obligations. New Rule II provides a method and procedure for these nonresidents to voluntarily comply with their obligation to file returns and pay taxes.

4. Concerned persons may submit their data, views, or arguments, either orally or in writing, at the hearing. Written data, views, or arguments may also be submitted to:

Cleo Anderson  
Department of Revenue  
Director's Office  
P.O. Box 7701  
Helena, Montana 59604-7701

and must be received no later than March 10, 2006.

5. Cleo Anderson, Department of Revenue, Director's Office, has been designated to preside over and conduct the hearing.

6. An electronic copy of this Notice of Public Hearing is available through the Department's site on the World Wide Web at [www.mt.gov/revenue](http://www.mt.gov/revenue), under "features," "administrative rules," and "upcoming events and proposed rule changes." The Department strives to make the electronic copy of this Notice of Public Hearing conform to the official version of the Notice, as printed in the Montana Administrative Register, but advises all concerned persons that in the event of a discrepancy between the official printed text of the Notice and the electronic version of the Notice, only the official printed text will be considered. In addition, although the Department strives to keep its website accessible at all times, concerned persons should be aware that the website may be unavailable during some periods, due to system maintenance or technical problems.

7. The Department of Revenue maintains a list of interested persons who wish to receive notices of rulemaking actions proposed by this agency. Persons who wish to have their name added to the list shall make a written request, which includes the name and mailing address of the person to receive notices and specifies that the person wishes to receive notices regarding particular subject matter or matters. Such written request may be mailed or delivered to the person in 4 above or faxed to the office at (406) 444-3696, or may be made by completing a request form at any rules hearing held by the Department of Revenue.

8. The bill sponsor notice requirements of 2-4-302, MCA, apply and have been fulfilled.

/s/ Cleo Anderson  
CLEO ANDERSON  
Rule Reviewer

/s/ Dan R. Bucks  
DAN R. BUCKS  
Director of Revenue

Certified to Secretary of State January 30, 2006